*United States Court of Appeals*

*for the Second Circuit*

# APPELLEE'S BRIEF

Signed

# 75-4124 75-4125

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

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AARON KRAUT and IRIS KRAUT,

Appellants

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee

---

HARRY KRAUT and MARIAN KRAUT,

Appellants

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee

---

ON APPEAL FROM THE DECISIONS OF THE UNITED STATES TAX COURT

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BRIEF FOR THE APPELLEE

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2

## TABLE OF CONTENTS



## CITATIONS

Cases:



Statutes:

Page

Miscellaneous:

IN THE UNITED STATES COURT OF APPEALS

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---

Nos. 75-4124 and 75-4125

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STATEMENT OF THE ISSUE PRESENTED

Whether the Tax Court correctly determined that the proceeds taxpayers realized in the bootstrap sale of stock to a tax-exempt organization were taxable as ordinary income

to the extent they exceeded the fair market value of the transferees' stock.

STATEMENT OF THE CASE

These appeals by Aaron and Iris Kraut, and Harry and Marian Kraut (sometimes hereinafter taxpayers) from decisions of the United States Tax Court. The Tax Court determined that Aaron and Iris Kraut owed a deficiency of $240,787.08 in income taxes for the year 1967 and that Harry and Marian Kraut owed a deficiency of $246,847.44 in income taxes for the same year. (R. 304-307.)[1] The findings of fact and opinion of the Tax Court (Honorable Arnold Raum), filed on June 27, 1974, are reported at 62 T.C. 420 (1974). (R. 273-303.) The Tax Court entered its decisions on February 21, 1975 (R. 304-307) and taxpayers Aaron and Iris Kraut and Harry and Marian Kraut filed their timely notices of appeal on May 19, 1975, and May 21, 1975, respectively (R. 308-309). Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

The pertinent facts may be summarized as follows:

Aaron Kraut and his brother, Harry, were in the business of developing and manufacturing electric wire of various types. They had, for at least 20 years, owned and acted as

1/ "R." references are to the separately bound record appendix.

president and vice-president, respectively, of Trio Wire and Cable Corporation (Trio) which was primarily concerned with the production of assorted types of wires and cables encased in plastic insulation. As an offshoot of Trio, the Kraut brothers in or around 1960, formed a separate corporation, the Christmas Wire Manufacturing Corporation (Christmas Wire). Through this corporation, the Kraut brothers hoped to penetrate the more specialized and very competive market for wiring used in the manufacture of Christmas decoration. (R. 275.)

Although Trio did not produce Christmas wire, it owned an extruder, a machine necessary to the production of such wire. Trio's extruder was housed in a leased building, one of several interconnected buildings in which Trio carried on its business. Christmas Wire used Trio's extruder in its manufacturing processes. The extruder constituted the only item of equipment used in the production of the Christmas wire. It appears that few employees were engaged in the manufacture of the Christmas wire. (R. 275.)

The most significant aspect of manufacturing Christmas wire was the extruding of a coat of plastic insulation around a light gage wire. The Christmas decoration manufacturers who purchased the wire then attached light blub sockets to the wire by means of small brass spurs on the sockets which punctured

the plastic jacket making contact with the electric wires inside. Manufacturers of Christmas wire, however, had encountered a problem arising from the tough consistency of the plastic sheathing used. The decoration manufacturers encountered difficulties in attaching the sockets through this insulation and had experienced high "rejection rate" in the decoration assembly process. As a result of various problems, primarily the rejection rate, the Kraut brothers brought production under Christmas Wire's name to an end sometime in the spring of 1965. Although the Krauts "sold" the Christmas Wire Corporation, the purchaser did not conduct operations at Christmas Wire's location. The sales price for the corporation was not established in the record. (R. 276.)

A short time thereafter, the Kraut brothers formed a new corporation, Nassau Plastic and Wire Corporation ("Nassau"). They intended to operate Nassau as an adjunct to Trio as they had Christmas Wire Manufacturing. Iris Kraut and Marion Kraut each contributed $100 to Nassau in exchange for 100 shares of stock in the corporation. Their husbands, Aaron and Harry, were not shareholders, but were the dominant forces in the corporation. (R. 277.)

Nassau occupied the building which Christmas Wire had previously occupied and there it kept its only equipment--the extruder owned by Trio which had previously been used by Christmas

Wire. Nassau used the extruder to manufacture Christmas wire with a new insulating material. This material was easily penetrable and thus was likely to minimize the rejection problems which had been associated with conventional plastic insulation. This new material, however, had yet to demonstrate its resistance to wear and decay over a period of several years. As such it was an unknown quantity. Although they assert that the new material was superior to other materials then in use, the Krauts did not apply for a patent on it. (R. 277.)

Nassau, on its federal income tax return for the fiscal year ending June 30, 1966, reported gross income of $26,189.84 which represented the difference between its sales of $492,305.16 and its cost of goods sold $466,115.32. Nassau reported no expenses for salaries or wages other than $2,600 paid to the Krauts. Nor did it report having incurred any expense for the use of the extruder or for rental of the building in which the extruder was kept. As of June 30, 1966, Nassau maintained no inventory. After deducting the Kraut's salaries, taxes, depreciation on a car and other operating expenses, Nassau reported a taxable income of $15,831.56. (R. 277-278.)

In early 1966, Management Methods, an investment counseling and legal firm from New York City, brought a proposal to one of its clients Reverend Rex T. Humbard, that he purchase Nassau.

Reverend Humbard was the pastor of the Cathedral of Tommorrow (Cathedral), a tax-exempt religious organization located in Akron, Ohio. Cathedral, among its other assets, owned two businesses, at least one of which it had acquired in a transaction financed entirely by debt. After expressing preliminary interest in the proposal concerning the purchase of Nassau, Reverend Humbard and his associates undertook to examine Nassau's business more closely. (R. 278.)

Before Cathedral and the Krauts entered into a binding agreement, however, Iris and Marion Kraut executed an agreement with the Wilson Mold & Die Corporation on May 31, 1966, purporting to sell Wilson their entire interest in Nassau. Beyond its participation in this contract, the record is devoid of any particulars with respect to Wilson or its principals. (R. 279.)

The day after the agreement between Wilson and the Krauts was executed, Trio and Nassau entered into an agreement under which Trio leased Nassau the extruder Nassau had previously used, along with its accompanying apparatus, for $500 per month. The lease was to run for a term of five years, but was to continue indefinitely thereafter, subject to either party's right to terminate the lease upon 60 days notice. The lease also provided that the lessors could determine the nature or extent of use of the machine and for anything other than insulating and spooling cooper wire. (R. 280.)

Fifteen days after their initial agreement, Nassau and Wilson abandoned their purported contract of sale. In a three-cornered agreement, Wilson assigned all of its rights and delegated all of its duties under the contract to Cathedral and the Krauts agreed to release Wilson from its prior commitments. Specifically, Cathedral's delegated duties were set out as follows (R. 281-282):

> The Buyer [Cathedral] shall take all such action as may be required so that on or as of June 25, 1966 Nassau Plastic shall be liquidated and all of its assets distributed to the Buyer. Simultaneously with the execution of this Agreement, the Buyer, with the consent of the stockholders and directors of the Sellers [Iris and Marian Kraut], shall take steps forthwith to accomplish the following:
>
> (a) Create a separate operating-manufacturing unit, owned by the Buyer, to be denominated and known as Nassau Plastic (hereinafter sometimes interchangeably referred to as "Nassau Plastic & Wire Co." * * *); the Buyer to file such documents with the proper governmental authorities as may be necessary to effectuate the same.
>
> (b) The name of Nassau Plastic & Wire Corp. shall be changed forthwith, to such name as the Buyer may designate.
>
> * * *
>
> The purchase price for all of the stock sold under this Agreement shall be not less than $500,000 (hereinafter called the "Minimum Price") nor more than $3 1/2 million (hereinafter called the "Maximum Price"). The purchase price shall be paid by the Purchaser to the Sellers at the following time in the following manner and to the extent set forth below:
>
> (a) For the period from June 25, 1966 to July 1, 1966, 100% of the net income of the Corporation shall belong

to the Sellers; the Purchasers shall receive credit for said amount toward the purchase price.

(b) $50,000 on or before August 1, 1966.

(c) For the balance of the year 1966 and in each of the years 1967 through 1976 terminating however on June 30, 1976 inclusive, unless the Maximum Price be paid in full prior thereto; commencing with the 15th day of October 1966 and on the 15th day of each January, April, July and October thereafter in respect to each preceding quarterly period from July 1, 1966 through June 30, 1976, an amount equal to 75% of the Corporations [sic] net income before Federal income taxes for each of such next preceding fiscal periods. In the event a loss occurs in any quarterly period, said loss shall be utilized as an offset in each of the succeeding quarterly periods (until said loss has been recouped) before payments to the Sellers are resumed.

(d) In any event and notwithstanding any provision in this Agreement with respect to the contingent deferral of installment payments of the Purchase Price, the full Minimum Price referred to above any portion of the Maximum Price referred to above which Sellers may become entitled to receive shall be paid in full on or before July 15, 1976.

(e) The Purchaser may prepay at any time all or any part of the unpaid amount of the Maximum Price.

The terms of payment agreed to by Cathedral were similar to those agreed to by Wilson. The only major difference was that Wilson had agreed to pay 75 percent of its pre-tax earnings through June 20, 1971, and thereafter pay 75 percent of its after-tax income while Cathedral agreed to pay 75 percent of its pre tax income for the entire ten year period. (R. 282.)

The transaction did not contemplate that the Cathedral would be required to make a cash outlay. Although there was to be an initial payment of $50,000 on August 1, irrespective of Nassau's profits, Nassau's assets at the time of the purported sale totaled over $52,000 and Cathedral was permitted to postpone payment of this amount until mid October of 1966, when Nassau had generated a cash-flow sufficient to pay the taxpayers. (R. 282-283.)

Wilson received no financial consideration for having assigned its rights to Cathedral. As the three-cornered agreement stated (R. 198):

> There shall be no payment from the Purchaser to Wilson Mold & Die Corp., the Assignor. It has been agreed that the consideration for the assignment shall be the release of the Assignor and the assumption of the duties and obligations by the Purchaser.

The agreement also stated that Wilson was unable to proceed with the purchase of the Nassau stock. (R. 195.) While the evidence concerning the particulars of the purchase by Wilson or Wilson's principals was sparse, the evidence that was introduced indicated that Wilson did not go through with the purchase because the purchase price for the stock was larger than the income which a non-exempt purchaser could realize from Nassau. (R. 31-32.)

The three-cornered agreement provided that the taxpayers were to retain a security interest in all of the assets, business and good will of Nassau, but that their interests were subordinate to prior liens and to "the rights of present and future general creditors for obligations arising in the regular course of

business, and liens, collateral or security for the loan or loans advanced or to be advanced by any bank." It was also provided that in the event of Cathedral's default, enforcement of the security agreement would constitute the seller's exclusive remedy--"and in no event shall the Seller's seek any deficiency judgment or other judgment for damages against the Buyer." (R. 283.)

Cathedral also agreed to employ Harry and Aaron Kraut as its chief executive officers. Aaron was to continue as production manager and internal office manager while Harry was to continue as sales manager. Thus, Cathedral gave them the full authority and responsibility to direct Nassau's business. In return for their services they were each to receive $5,200 yearly. Their employment was to terminate on the day following the date of Cathedral's final payment to their wives. (R. 283.)

Nassau, at the time of the agreement, owned neither the building in which it operated nor the single piece of machinery it used to produce Christmas wire. Its interest in the machinery consisted of a five-year lease. It had total assets of $53,867.56, $50,089.75 of which were accounts receivable. At the same time, it had $36,575.99 of accounts payable. (R. 284.)

After the sale of stock, Nassau continued operations, with a slightly changed name, at the same location, under the same management and with the same equipment. The business became very successful during the remainder of 1966 and 1967. The

Cathedral paid Iris and Marian, $97,500 in 1966 and $1,332,500 in 1967. (R. 285.) After 1967, however, the business became unprofitable and in 1969 operations ceased. The apparent cause of this turnabout was the ability of Nassau's competitors, through improved technique and production quality, to reduce the rejection rate of their Christmas wire. (R. 285.)

Taxpayers reported the receipt of $666,250 in each of their joint income tax returns for the year 1967. They each treated $27,720.83 as interest, deducted $32,112.50 as collection expenses and reported the remaining $606,416.67 as long-term capital gains. The Commissioner determined that $595,776.09 of each couple's receipts in 1967 was taxable as ordinary income. (R. 286.) He computed this amount by deducting reported interest, selling expenses and the determined value of Nassau's stock from taxpayers' receipts under the sales contract. He assigned a value of $166,445.60 to Nassau's shares, an amount equal to ten times Nassau's taxable income for the year ended June 30, 1966.[2/]

2/ Nassau's federal income tax return for the year ending June 30, 1966, indicated taxable income of $15,831.56. In his statutory notice of deficiency the Commissioner determined Nassau's taxable income for that year to be $16,844.56.

Taxpayers then filed petitions in the Tax Court contesting this determination and contending that the property sold was a capital asset so that the gain therefrom was taxable only as long-term capital gain. (R. 9-11, 14-16.) The Tax Court rejected that contention and held that taxpayers failed to prove the existence of a bona fide sale to the Cathedral and had failed to show that the stock transferred to the Cathedral had a value in excess of $168,445.60, as allowed by the Commissioner. Accordingly, it sustained the Commissioner's determination that $595,776.09 of each couple's receipts should be taxed as ordinary income. (R. 29-31.) From these adverse decisions the taxpayers appeal. (R. 308, 309.)

## SUMMARY OF ARGUMENT

This case presents the question whether all the proceeds taxpayers realized in the bootstrap sale of the stock in their closely held corporation to a tax-exempt organization qualify for taxation as capital gains rather than ordinary income. Prior to the Tax Reform Act of 1969, businessmen could sell their businesses to tax-exempt organizations in bootstrap sales so that the profits generated in the conduct of the business would filter through to the "selling" businessman with a minimum of tax cost. In Berenson v. Commissioner, however, this Court held that, in a bootstrap sale of a closely held corporation to a tax-exempt organization, only that portion of the proceeds which equalled the price a nonexempt organization would have paid under identical circumstances, qualifies for preferential capital gains treatment. We submit that the Tax Court below reached the result mandated by this Court's Berenson opinion.

The price the exempt organization agreed to pay for the Nassau stock was greatly in excess of fair market value. The price which taxpayers were to receive for their stock was not fixed, but was to range from $500,000 to $3,500,000, depending on the future earnings of the business taxpayers sold. And if the business failed to generate sufficient profits or meet this variable purchase price, the only remedy to the sellers

was to reclaim the business. This business, in turn, was a very speculative venture. The corporation's earnings were limited and its assets were few. In essence, the only asset of value which Nassau had was the means of making a new type of wire. Yet neither the corporation nor its owners sought to patent this process. Thus when the purported transaction took place the earnings of the corporation in future years could only be described as speculative. As the Tax Court noted, the Commissioner was perhaps even generous when he determined that the business was worth approximately $170,000. There is clearly no basis for overturning the Tax Court's determination that only $170,000 of the taxpayers' proceeds represents proceeds which qualify for capital gains taxation.

Taxpayers, however, urge that they showed the corporation was worth more than $170,000. There is no merit to their contentions. They provided no expert testimony as to the stock's value and relied instead only upon the testimony of one interested witness. His testimony, in turn, was vague and unspecific and provides no basis for overturning the Tax Court's findings. Taxpayers also point to a prior purported sale of the stock to Wilson Corporation. Yet there is no evidence that this purported transaction was anything other than a ploy taxpayers used to give credence to their assertion that the exempt organization agreed to purchase the Nassau stock at fair market value.

Finally, there is no support for taxpayers' assertion that the fair market value of the stock could not be less than 48 percent of the price which Cathederal agreed to pay for the Nassau stock. As this Court has recognized, a fair sales price is determined by factors other than the buyer's tax bracket. Taxpayers produced no credible evidence to show that the Commissioner's determination of the value of the stock here at issue was not correct. The Tax Court was correct in sustaining that determination. Its decision should be affirmed.

## ARGUMENT

### THE TAX COURT CORRECTLY DETERMINED THAT THE PROCEEDS TAXPAYERS REALIZED IN THE BOOTSTRAP SALE OF STOCK TO A TAX-EXEMPT ORGANIZATION WERE TAXABLE AS ORDINARY INCOME TO THE EXTENT THEY EXCEEDED THE FAIR MARKET VALUE OF THE TRANSFEREES' STOCK

#### A. Introduction

In 1966, taxpayers entered into an agreement to sell their stock in Nassau Plastic and Wire Corporation, to Cathedral of Tommorrow, a tax-exempt religious organization. The sales price, which was dependent upon Nassau's future profits, was to range from a minimum of $500,000 to a maximum of $3,500,000 and was entirely payable from the business' income for the following ten years. The taxpayers' husbands, who formerly ran the corporation, were retained as employees by Cathedral, and as such remained in control of the operation of the business.

This appeal presents the question whether the Tax Court properly held that the sales proceeds received by taxpayers, to the extent they exceed the fair market value of the transferred stock, are taxable as ordinary income, rather than capital gain income, as taxpayers had reported them.3/

This case represents another example of a recurring situation in which businessmen, prior to the enactment of the Tax Reform

3/ Contrary to taxpayers' brief (pp. 31-32), we no longer contend that none of the sales proceeds qualify for capital gains taxation. Instead, we merely contend that the portion of the sales price that exceeds the price obtainable from a non-exempt purchaser does not qualify for capital gains taxation.

Act of 1969, sold their businesses to tax-exempt organizations in bootstrap sales. The basic scheme was one that was designed to let profits generated in the conduct of a business filter through to the "selling" businessman with a minimum tax cost. This could be accomplished because churches which qualified under Section 501(c)(3) of the Internal Revenue Code of 1954 (26 U.S.C.) were exempted from income tax and from the tax on unrelated business taxable income. Section 511(a)(2)(A), Appendix, _infra_.[4/] Thus, a qualified church could generally receive the income from the operation of a trade or business, which was unrelated to the church's exempt purpose, without incurring tax liability on the business' income.[5/] But cf. Treasury Regulations on Income Tax (1954 Code), § 1.511-2(a)(3)(ii) (26 C.F.R.). This tax feature formed the basis for the bootstrap sale. Generally these bootstrap sales proceeded in the following fashion: A tax-exempt organization offers to buy the stock of a successful, family-owned corporation; the exempt organization, rather than paying cash for the stock, however, only obligates itself to pay for the stock out of profits generated by the business after the sale; thus, the "sellers" are given non-recourse notes, secured by a mortgage on the assets of the corporation they once owned; the charity (or some third entity

4/ Section 511(a)(2)(A) has since been amended so that churches are subject to the unrelated business tax.

5/ See, Note, _Bootstrap Sales to Tax-Exempt Foundations and the Tax Reform Act of 1969_, 39 U. Cin. L. Rev. 144 (1970).

specially formed to "rent" the business assets from the charity)[6/] then hires the "sellers" to operate "its" business and, with the tax-free income it receives from the operation of the business, the exempt organization pays off its "debt" to the "sellers." The "sellers" thus receive substantially all the profits generated by their efforts in what once was their business as part of the "sales price" for their stock. These profits, which pass through the tax-exempt organization business layer free of any federal tax, are, in turn, reported by the "sellers" as the proceeds from the sale of capital assets and therefore taxable at capital gains rates. The schemes thus provide a very convenient way for owners of corporations to pull out virtually free of tax costs a very substantial amount of the profits they generate in operating their business. This Court in the recent case of <u>Berenson</u> v. <u>Commissioner</u>, 507 F. 2d 262 (C.A. 2, 1974), examined the tax consequences of such a transaction in circumstances almost identical to those presented here.

B. <u>The Berenson case</u>

<u>Berenson</u>, like the instant case, involved the purported transfer of the stock of a family-owned closely held corporation to a tax-exempt organization. This Court in <u>Berenson</u> held that only the proceeds of the purported sale which did not exceed the

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6/ A formalism dictated by the application of the unrelated business income tax to some exempt organizations.

fair market value of the stock to a nonexempt purchaser were entitled to capital gains treatment.

In Berenson, supra, several taxpayers owned all the capital stock of two corporations which were engaged in the manufacture and sale of women's sportswear. The taxpayers had operated these closely held, family corporations successfully for a number of years. On December 31, 1965, the taxpayers sold all of their stock in the corporations to Temple Beth Ami, a nonprofit religious organization, exempt from federal income tax and from the tax upon unrelated business income.

The Temple agreed to pay the taxpayers $6,000,000 for their stock. This price, which was considerably in excess of the price a nonexempt purchaser would have paid for the stock, was payable solely out of business profits over a period of 13 years. The Temple was not required to make a down payment on the purchase price of the stock and, in the event of default in payment of the purchase price, was only obliged to return its capital account in the business formerly conducted by the corporation to the sellers.

Upon acquiring the stock, the Temple liquidated the corporations and formed a limited partnership to run the businesses. This partnership then hired the former stockholders to manage the businesses.

Thus, the tax-exempt organization made no outlay of its own funds and risked none of its property in the purchase. Further the management of the underlying businesses was left completely

undisturbed by the sale of the stock. The Tax Court (Berenson v. Commissioner, 59 T.C. 412 (1972)) held that the gain the purported sellers had realized in this transaction did not qualify for capital gains taxation. As it viewed the transaction, the purported sale of stock did not constitute a sale for tax purposes, but was instead mere artifice.

This Court (507 F. 2d, p. 262) reversed in part and affirmed in part. Based upon its analysis of the Supreme Court's decision in Clay Brown (Commissioner v. Brown, 380 U.S. 563 (1965)), this Court held that, under the facts presented, a sale within the meaning of Code Section 1222(3) (26 U.S.C.) (the long-term capital gain provision) had occurred and that the amount realized on such a sale undoubtedly included amounts which represented the appreciation in the value of the businesses that had accrued prior to the date of sale. This portion of the sales price qualified for capital gains taxation. However, to the extent the price paid by the tax-exempt purchases exceeded the value of the stock to a nonexempt purchaser under identical terms, the sales price did not represent the type of receipt the capital gains provisions were designed to cover.

In so holding, this Court distinguished the Supreme Court's decision in Clay Brown. In that case, the Supreme Court had held that the proceeds realized in the bootstrap sale of a closely held corporation to a tax-exempt charitable institution qualified for treatment as capital gains.

However, the sales price in Clay Brown was within a reasonable range given the net worth and earnings history of the company. Specifically, the appraised net worth of the assets of the business in Clay Brown was $1,064,877 and they were sold for $1,300,000, the premium readily explainable in terms of the business' favorable earnings history.

This Court stated in Berenson (507 F. 2d, p. 268):

> We agree with the majority of the Tax Court that, because of the finding that the purchase price in this transaction was substantially in excess of what a nonexempt purchaser would have paid for the business under identical terms, Clay Brown does not compel the conclusion that all of the proceeds of the sale must be afforded capital gains treatment. The Supreme Court took such pains to explain the significance of the Tax Court's finding in Clay Brown that the purchase price was within a reasonable range in view of the adjusted net worth and earnings history of the company, that we cannot escape the conclusion that the Court would have found itself presented with a substantially different problem had there been a finding of an excessive purchase price such as that here and would have reached a different result.

This Court went on to reject the taxpayers' contention that because a tax-exempt buyer had agreed to pay a designated sales price in an arms-length transaction, that sales price could in no way be called excessive. Berenson, supra, pp. 268-269:

> Admittedly, the Tax Court did not find that the price was unreasonably high from the point of view of an exempt purchaser. Indeed, since

> the transaction here was arrived at through good faith bargaining and was not a sham, the conclusion seems inescapable that the agreed upon price was within a reasonable range for a tax-exempt purchaser. However, Congress has long regarded the impact upon the market place of an exempt organization's ability to conduct a business free from income taxation as an unwholesome form of discrimination. The same tax exemption which gives an unfair competitive advantage to an exempt organization in the operation of a business also permits it an unfair degree of purchasing power in the acquisition of such a business. We think it would be inappropriate to include an increase in value, attributable solely to the presence of such unfair purchasing power, within the past accrued appreciation that the capital gains provisions seek to shield from taxation at ordinary rates. We therefore reject Taxpayers' contention.

This Court therefore concluded that only a portion of the amounts taxpayers received for their stock from the tax-exempt buyer qualified for capital gains taxation (507 F. 2d, p. 269):

> In sum, we conclude that the portion of the purchase price agreed to by Temple and Taxpayers that is in excess of the price a nonexempt purchaser would have paid under identical terms is not part of the proceeds of a §1222(3) "sale," and is, therefore, taxable as ordinary income to the recipients.

This case is on all fours with <u>Berenson</u>. Here, as in <u>Berenson</u>, the price paid by the tax-exempt buyer for the stock was greatly in excess of its fair market value. This excessive sales price was payable entirely out of profits to be generated by the business. If the business failed to do as well as required in

order to meet this excessive sales price, the only recourse the sellers had was to reclaim the business. (R. 283.) Finally, the transferred business was to remain under the managerial control of the sellers. Indeed, in one respect the present case represents an even more egregious example of a bootstrap sale than did Berenson. In Berenson, the parties at least agreed on one fixed, albeit excessive, sales price. Here, on the other hand, the parties could not even do that. Instead, they agreed only to a flexible price keyed to future business profits. Neither here nor in Berenson was the sales price a realistic one. Rather, the fixed price in Berenson and the variable purchase price here reflected not, "the realization of appreciation in value accrued over a substantial period of time" but the future income that the transferred businesses were capable of producing.

Taxpayers here retained the right to receive substantially all the profits generated by the transferred business--in fact, taking account of tax benefits they hoped to garner, they stood to receive an even larger share of the profits than before the "sale." The Tax Court correctly determined that the transaction constituted "a retained proprietary interest by the shareholders in the business' future earnings rather than the creation of a creditor's interest in future earnings born of past accrued value of a capital asset." (R. 292.) Under the clear teaching of this

Court's decision in Berenson, only that portion of the sales price that represents the amount taxpayers would have received from a non-exempt purchaser can qualify for the capital gains rates. We submit that the Tax Court was correct in sustaining the Commissioner's determination that to such a non-exempt buyer the Nassau stock would have had a value of no more than $168,445.60 and in holding that the amounts taxpayers received in excess of that amount were subject to tax as ordinary income.

C. The fair market value of the stock

In his statutory notice of deficiency, the Commissioner determined that the value of the Nassau stock was $168,445.60, rather than the variable price of $500,000 to $3,500,000 which the taxpayers claim constitutes a reasonable price. The circumstances surrounding the transaction and the taxpayers' failure to adduce any evidence in support of their claim, compels the conclusion that the Commissioner's determination was correct.

As this Court has recognized, a trial court's determination of a stock's value is a question of fact Seas Shipping Co. v. Commissioner, 371 F. 2d 528 (C.A. 2, 1967), which should not be disturbed on appeal unless clearly erroneous. Commissioner v. Duberstein, 363 U.S. 278 (1960). Among those factors to be considered in valuing a closely held stock are the following: corporate assets, earnings, earning power of the corporation, book value, character of the management and financial structure

of the corporation. Arc Realty Co. v. Commissioner, 295 F. 2d 98 (C.A. 8, 1961); 9A Mertens, Law of Federal Income Taxation, Sec. 59.21. In applying these criteria to the instant case, it is clear that the value of the Nassau stock was not greater than ten times its earnings in 1965.

At the time of the transaction here, Nassau had been in business for little over a year and its earnings for that year were not great. On its federal income tax return for the year ended June 30, 1955, Nassau reported gross income of $26,189.84 which represented the difference between its sales of $492,305.16 and its cost of goods sold $466,115.32. After deducting the Krauts' salaries, taxes, depreciation on a car and $5,913.40 in operating expenses, Nassau reported a taxable income of only $15,831.56. (R. 277-278.)7/

By the same token, the corporation owned few assets. It owned no manufacturing equipment, no tools and no buildings. Indeed, its only assets apparently were an automobile and a lease on the extruder which it used to manufacture Christmas wire. Of the $53,867.56 of total assets listed on its tax return, fully $50,089.75 was attributable to notes and accounts receivable. (R. 284.)

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7/ As noted in the Commissioner's brief below (Br. 27-28), the Commissioner, in his statutory notice of deficiency determined that Nassau's taxable income was $16,844.56.

In essence the only asset of any value which Nassau had, was the means of making this new wire. But the value of this technology was quite clouded. Neither Nassau nor its owners obtained a patent for the process of manufacturing this wire, and could therefore not prevent Nassau's competitors from employing the same techniques that Nassau used. And the entire process was still unproved. Indeed, when Aaron Kraut was asked why Trio did not manufacture this "dramatically exciting type of Christmas wire" (Br. 4), he responded (R. 81):

> Well, the soft plastic material had a particular drawback, it was an unknown quantity, we didn't know how it would react two or three years after it was manufactured, and after several discussions with our accountant and attorney, we decided that we would be complete idiots to take a chance on putting--producing this material in Trio wire and jeopardizing the corporation.

If there were doubts about the durability of its product, any estimate of Nassau's prospects in future years could only be described as speculative. Accordingly, the Commissioner was generous when he determined that the value of the Nassau stock was $168,445.50--ten times the pre-tax earnings of Nassau during its only year of existence. Taxpayers, however, assert that the fair market value of the Nassau stock was $3,500,000 or more. (Br. 29.) In making this assertion, they fail to mention that the purported purchase price of the Nassau stock could vary between $500,000 and $3,500,000 depending upon Nassau's

That testimony provides no basis for valuing the Nassau stock at a higher level than the Commissioner determined was appropriate and that the Tax Court adopted for its decision.

Taxpayers (Br. 19) also point to the prior purported sale of the stock to Wilson Corporation as evidence that the Nassau stock was worth more than $168,000. However, there is no evidence that the Wilson Corporation ever intended to proceed with the purchase of the stock. Indeed, taxpayers presented no evidence as to what business Wilson was in, who conducted it, who its principals were or what negotiations preceeded the signing of the contract. The "contract" with Wilson was signed after taxpayers had begun negotiating with Cathedral and the contract with Wilson had a total life of only 15 days. At that time Wilson, whoever and whatever it was, assigned all its interest in the purported purchase agreement to the Cathedral. (R. 296.) Although Wilson had supposedly purchased a valuable and growing business, the consideration it received for assigning its rights to Cathedral was stated in the three cornered agreement as follows (R. 198):

> There shall be no payment from the Purchaser to Wilson Mold & Die Corp., the Assignor. It has been agreed that the consideration for the assignment shall be the release of the Assignor and the assumption of the duties and obligations by the Purchaser.

It seems highly unlikely that a party who had contracted to buy the stock of a prospering business would assign that right to another party without cash consideration, if it had truly intended initially to purchase the business. Indeed, the only testimony presented as to why Wilson was unable to proceed with the purchase, was that Wilson would lose money on the contract because it would be required to pay income tax on the net income of Nassau Corp., and also to make payments consisting of 75 percent of Nassau's net income to the Krauts. Thus, throughout the term of the contract, Wilson would be forced to make payments which were in excess of Nassau's after-tax income. And the greater Nassau's income, the greater the deficit Wilson would incur. (R. 51-52.) 9/ It is somewhat surprising that such a fact would not occur to a good faith purchaser before entering into a contract of purchase, so surprising in fact that it casts considerable doubt upon the whole Wilson contract. It seems clear that Wilson, if it ever was more than a mere corporate shell, had not entered into arms-length bargaining with taxpayers to reach a fair price for the stock. Rather, the

9/ Although taxpayers stated (Br. 19) that Wilson had a net operating loss carry-over that could be utilized to offset Nassau's income, this is mere speculation. If Wilson was anything more than a shell corporation designed to give weight to taxpayers' assertion of the value of Nassau, the proper place to have introduced such evidence was in the Tax Court.

agreement seems to have been a means by which taxpayers could give credence to their assertion that Cathedral agreed to purchase the Nassau stock at fair market value.

Finally, taxpayers argue (Br. 33) that the fair market value of the Nassau stock could not be less than 48 percent of the price which Cathedral agreed to pay for the Nassau stock.[10/] This argument is best refuted, however, by this Court's decision in Berenson. There this Court found that the purchase price which the exempt organization had agreed to pay was arrived at after good faith bargaining, was not a sham and was within a reasonable range. Yet in order to determine what price a nonexempt purchaser would have agreed to pay, this Court found it necessary to remand the case to the Tax Court, 507 F. 2d, p. 269:

> * * * to separate the purchase price into the portion that is attributable to the accumulated value of the corporation at the time of the purchase and the portion attributable solely to the extra purchasing power possessed by Temple by virtue of its tax-exempt status.

This Court did not merely determine the fair market value of the stock in Berenson by substracting from the fixed purchase price

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10/ In so asserting taxpayers again fail to mention that the purchase price of the stock could vary between $500,000 and $3,500,000 and that taxpayers only received $1,480,000 for their stock.

which the exempt organization had agreed to pay, an amount which was (Br. 34) "the amount of the corporate tax in effect at the time of his purchase." Indeed, as Justice Harlan noted in Clay Brown an organization's exemption, 380 U.S., p. 580:

> * * * is unlimited, like the magic purse that always contains another penny, the Institute gave up nothing by trading on it.

Thus as this Court noted in Berenson a tax-exempt organization will pay substantially more for a business than a non-exempt purchaser would agree to pay. There is thus no correlation between a nonexempt purchaser's tax bracket, the price it is willing to pay to acquire stock and the price which an exempt organization is willing to pay to acquire a corporation.

The Commissioner determined that the fair market value of the Nassau stock was $168,445.60--ten times the corporation's earnings in its only year of existence. Taxpayers produced no credible evidence which would show that this determination was not correct. As such only $168,445.60 of the proceeds which the taxpayers received is entitled to capital gains treatment.

## CONCLUSION

For the reasons stated above, the decision of the Tax Court should be affirmed.

Respectfully submitted,

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## CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel by mailing two copies thereof to each on this 5th day of September, 1975, in envelopes, with postage prepaid, properly addressed to each of them, respectively, as follows:

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## APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 511. IMPOSITION OF TAX ON UNRELATED BUSINESS INCOME OF CHARITABLE, ETC., ORGANIZATIONS.

(a) <u>Charitable, Etc., Organizations Taxable at Corporate Rates</u>.--

* * *

(2) <u>Organizations subject to tax</u>.--

(A) [as amended by Sec. 3(a), Act of July 14, 1960, P.L. 86-667, 74 Stat. 534; Sec. 2, Act of February 2, 1966, P.L. 89-352, 80 Stat. 4] Organizations described in section 501(c)(2), (3), (5), (6), 14(B) or (C), and (17) and section 401(a).--The taxes imposed by paragraph (1) shall apply in the case of any organization (other than a church, a convention or association of churches, or a trust described in subsection (b)) which is exempt, except as provided in this part, from taxation under this subtitle by reason of section 401(a) or of paragraph (3), (5), (6), 14(B) or (C), or (17) of section 501(c). Such taxes shall also apply in the case of a corporation described in section 501(c)(2) if the income is payable to an organization which itself is subject to the taxes imposed by paragraph (1) or to a church or to a convention or association of churches.